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IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-98

JACK'S COOKIE COMPANY,
Petitioner

v.

THE UNITED STATES OF AMERICA,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

JAMES O. MOORE
GEORGE R. HODGES
MOORE AND VAN ALLEN
3000 NCNB Plaza
Charlotte, North Carolina 28280

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Jack's Cookie Company petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fourth Circuit in this case.

OPINIONS BELOW

The findings of fact and opinion of the district court (Appendix A, *infra*, p. 1a) are not reported. The opinion of the Court of Appeals (Appendix B, *infra*, pp. 2a-24a) is reported at 597 F.2d 395.

JURISDICTION

The judgment of the Court of Appeals was entered on April 25, 1979 (Appendix C, *infra*, p. 25a). The peti-

tioner's timely filed petition for stay of mandate was denied on May 29, 1979 (Appendix D, *infra*, p. 26a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTION PRESENTED

Whether a payment by a lessee to the lessor denominated and required by the lease, State Industrial Revenue Bond Acts and the County Resolution as current rent is deductible at the time of payment as an ordinary and necessary rental expense under Section 162(a)(3) of the Internal Revenue Code.

STATUTES INVOLVED

The pertinent provisions of the Internal Revenue Code of 1954 and the Tennessee State Statutes (1954 Code) are set forth in Appendix E, *infra*, pp. 27a-28a. The pertinent provisions of the lease agreement are set forth in Appendix F, *infra*, pp. 29a-37a.

STATEMENT

Petitioner leases a fully equipped industrial plant from Giles County, Tennessee, pursuant to a lease dated June 1, 1962. (Appendix F, *infra*, p. 29a). The term of the lease is thirty years, with options for extension totalling an additional thirty years. (Appendix F, *infra*, p. 29a-30a).

Giles County, Tennessee, (the County), financed the construction of the plant through two bond issues pursuant to the Tennessee Industrial Building Revenue Bond Act of 1951 [1] and the Tennessee Industrial Building Bond Act of 1955.[2] State law requires that part of the rental

[1] *Tenn. Code Annot.* § 6-1704 (1970 Supp.), Appendix E, *infra*, p. 27a.

[2] *Id.* at § 6-1715. Appendix E, *infra*, p. 28a.

payments be used to create "reserves" sufficient to pay the bonds used to finance the industrial buildings,[3] and the County resolution for the bonds required the establishment of a reserve fund.[4]

The lease agreement between petitioner and the County was entered into pursuant to the above statutes and resolution. The rent was set at the amount equal to the present obligations on the bonds, the cost of servicing them, and a set sum to be placed in the reserve fund to retire the bonds. Specifically, the "monthly rentals" were to equal one-sixth of the semi-annual interest on the bonds, one-twelfth of the next annual principal payment due on the bonds, the expenses of administering the bond issues, and "reserve payments" in an aggregate of $285,000 payable in equal monthly installments over the

[3] *Id.* at §§ 6-1704 & 6-1715.

[4] The resolution of June 1, 1962, of Giles County provides:

> Section 7. That there shall be and there is hereby created an account to be known as the "Giles County Industrial Building Revenue and Tax Deficiency Bond and Interest Redemption Fund" (hereinafter sometimes referred to as the "Bond Fund") into which there shall be paid and set aside such portion of the income and revenues from said industrial building as will be sufficient to pay promptly the interest on and principal of the bonds herein authorized as same become due. All accrued interest received at the time of issuance of the bonds shall be deposited in the Bond Fund, together with a sufficient portion of the proceeds of the bonds, to aggregate the sum of $150,000.00, which sum is hereby found to be necessary to pay a portion of the interest on the bonds during construction of the industrial building and which sum shall be used solely for that purpose.
>
> From the income and revenues of said industrial building there shall be placed on the tenth day of each month in the Bond Fund a sum equal to one-sixth (1/6) of next semi-annual interest due plus one-twelfth (1/12) of next annual principal due plus the Reserve payment and Trustee's fee.
>
> * * * *

first 15 years after occupancy (i.e. $20,479.08 per year). (Appendix F, *infra*, p. 30a). This "monthly rental" is required by the Tennessee statutes, the County Resolution, and the lease and must be paid as a condition of petitioner's present and continued use of the plant. If petitioner should fail to remit any portion of the total rent due, including the reserve element, the county may cancel the lease unless the arrears are promptly cured. It is only the "reserve payment" element of the monthly rental that the Government has challenged.

The lease gives petitioner the option to prepay the remaining rent at any time after the fifteenth year. (Appendix F, *infra*, p. 31a). Exercise of the option would require a payment sufficient to retire the bond issues, i.e., the aggregate of remaining rental payments less the amount in the reserve fund. (Appendix F, *infra*, p. 31a).

Petitioner paid the full "monthly rental" in 1970. This includes the $20,479.08 reserve fund element as well as the other elements of the rent. The rental payments were made from Jack's current operating income. In accordance with generally accepted accounting principles, petitioner treated the *total* rental payment as a current expense in its yearly financial statement and deducted it as a current rental expense in its 1970 federal income tax return.

The Internal Revenue Service allowed as a present deduction three elements of petitioner's rent. It disallowed only petitioner's deduction of the reserve fund element. That increased petitioner's tax liability by $9,829.96 plus interest. Petitioner paid that additional tax and in this action sued for a refund. The district court found for the taxpayer, holding that the reserve fund elements are deductible in the year paid because they are a current expense necessary for present occupation of the plant. The court of appeals reversed, finding that the payments were not a presently deductible rental expense.

REASON FOR GRANTING THE WRIT

1. The United States Court of Appeals for the Fourth Circuit misapplied the decision of this court in *Commissioner* v. *Lincoln Savings and Loan Association*, 403 U.S. 345 (1971). *Lincoln* held that certain insurance premium payments created for the taxpayer "a separate and distinct additional asset" and thus, were not deductible in the year of payment. *Lincoln*, *supra*, 403 U.S. at 35. The factors listed by the *Lincoln* court as making the questioned payment a separate asset are not present here. In *Lincoln*, the reserve fund could be used to pay losses and only to the extent that other assets were unavailable therefor; the County may use its reserve fund to meet any current obligations or expenses of the revenue bonds for which the current rental payments are insufficient. Petitioner has no "distinct and recognized property interest" in the reserve fund. The lease (Appendix F, *infra*) grants petitioner no right to transfer the fund; indeed petitioner has no interest in the fund to transfer. There is no possibility that petitioner will obtain a refund of its reserve element payments, nor will the fund automatically be used to discharge petitioner's future rental obligations. It may be so used only if petitioner elects to prepay, and does prepay, all remaining rental payments, with no discount for early payment. Neither petitioner nor the County treats the reserve fund as if it were property in which petitioner has a property interest. Both regard and treat the fund as property of the County held for the purpose of securing payment of the bonds.

The Court of Appeals concluded that the reserve fund was a separate and distinct asset of the petitioner but failed to point out how it reached that conclusion. See

Appendix B p. 2a, *infra*. In order for the fund to be an asset of the petitioner, the petitioner must have some property interest in it. Petitioner has no identifiable property interest in the fund, and none was found by the court of appeals. Therefore, the fund cannot be an asset of the petitioner and the application of *Lincoln* was improper.

This case would give the Court an opportunity to clarify the standard and proper application of the *Lincoln* case so that expenditures will not automatically be considered separate asset whenever they may potentially produce a benefit beyond the present taxable year.

2. Disallowing the rental expense deduction for the year in which it was paid distorts petitioner's financial position for that and future years. The Internal Revenue Code provides that "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his "books," unless that method does not "clearly reflect income." Internal Revenue Code § 446(a) and (b). Petitioner treated all of the rental paid as an expense in its records for the year in question. Because petitioner presently has no interest in the reserve fund and no right to the money contained in it, its accounting method clearly reflects its income, and is the only method that will do so. From petitioner's standpoint, the reserve element of its rental payments are indistinguishable from the other elements: all are required to be paid currently, and all are forever gone from petitioner's treasury and control. Disallowance of the deduction in the year paid forces inclusion in petitioner's income for that year funds that it does not presently hold and to which it has no claim. Deduction in later years reduce petitioner's income below its actual level.

The reserve fund is unlike prepaid rent in that the lessee, the petitioner here, cannot lay claim to these

funds nor command its use in a certain manner unless it is willing to prepay all remaining rentals at their face value. Prepaid rent is an asset that the lessor can use only in a certain manner; the reserve fund can be used by the County as rent, if all rent is prepaid, or to meet current and unexpected expenses on the underlying bonds.

Because of the unique nature of the reserve fund, inclusion of that amount in income in the year of payment inaccurately reflects petitioner's income for that and future years.

3. The rental expense deduction claimed by petitioner fulfills the statutorily imposed requirements for that deduction. The applicable statute provides:

> "There shall be allowed as a deduction all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . rentals or other payments required to be made as a condition to the continued use or possession . . . , of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

Internal Revenue Code § 162(a)(3). The reserve element of rental paid was required both by the lease agreement and state law as a condition to present and continued use. Appendix F, *infra*, p. 36a; Tenn. Code Annot. §§ 6-1715, Appendix E, *infra*, p. 28a. All parties to the lease agreement regard the reserve element as a part of present, not future rent. The possibility of an ensuing future benefit should not override the basic characteristic of the payment.

The court of appeals' decision conflicts in principle with that of the Fifth Circuit in *Benton* v. *Commissioner*, 197 F.2d 745 (5th Cir. 1952) and with that of the Tax Court in *WSBR, Inc.* v. *Commissioner*, 30 T.C. 747 (1958). Both of those decisions held that rental payments made

under a lease granting the lessee an option to buy at a low sales price were properly deductible in the year of payment as a rental expense. In *WSBR*, the lease option set an option price that, by its terms, was to be reduced by the amount of rental paid under the lease. Both courts regarded as controlling the parties' intentions that the sums denominated by the leases as rent were to be current rent and not a prepayment of the sales price, that the sums were required as a condition to the continued use of the lease property, and that the purchase prices were not, at the time of the agreement, unreasonably low.

Petitioner's situation is analogous. The reserve element was intended by the parties to be current rent. It was required by state law to be included in current rent. The petitioner must pay all rent, including the reserve element, to remain in possession. There does remain a possibility that at some time in the future, the reserve fund will be used in a way that will benefit the petitioner. That future benefit is certainly no greater than in the *WSBR* case. If the contingency should occur, then the benefit to petitioner can and will be included in its income at that time and in the exact amount it is benefitted. The method of accounting for the reserve payment advanced by petitioners is the simplest and most accurate means of determining the tax consequences of the reserve element.

Unquestionably, the reserve payment is rent; the lease, the state statutes, and the County Resolution require it to be part of current rent. The applicable Code provision allows a deduction for all rentals paid or incurred during the taxable year. Petitioner made all rental payments, including the reserve element. The text of the statute requires that a deduction for all rental paid by petitioner be allowed.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

JAMES O. MOORE, ESQUIRE
GEORGE R. HODGES, ESQUIRE
MOORE AND VAN ALLEN
3000 NCNB Plaza
Charlotte, North Carolina 28280
Telephone: (704) 374-1300

July, 1979.

Appendices

APPENDIX A

UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF NORTH CAROLINA

No. C-C-75-358

Filed June 10, 1977

JACK'S COOKIE COMPANY,
Petitioner

v.

UNITED STATES OF AMERICA,
Respondent

This matter is before the Court on the plaintiff's and defendant's cross motions for summary judgment. Upon consideration of the stipulated facts and the briefs and arguments of counsel, the Court finds that there are no disputed material facts and concludes that the plaintiff is entitled to summary judgment as a matter of law.

IT IS THEREFORE ORDERED, ADJUDGED, and DECREED that: the plaintiff have and recover of the defendant: (1) the principal amount of its deficiency payment ($9,829.96) and the interest on that principal amount paid to the defendant ($1,646.17); plus (2) interest at the rate of nine percent (9) per annum [or such other rate of interest as established by the Commissioner of Internal Revenue pursuant to 26 U.S.CA. § 6621(b)] on those sums from August 3, 1973, to a date determined by the Commissioner of Internal Revenue not preceeding the date of the refund check by more than 30 days; plus (3) its costs in this action.

This the 10 day of June, 1977.

/s/ James B. McMillan
United States District Judge

APPENDIX B

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 77-2210

JACK'S COOKIE COMPANY,
Appellee

v.

THE UNITED STATES OF AMERICA,
Appellant

April 25, 1979

On Appeal from the United States District Court for the Western District of North Carolina, at Charlotte.

James B. McMillan, District Judge.

Before BRYAN, Senior Circuit Judge; BUTZNER, Circuit Judge, and FIELD, Senior Circuit Judge.

FIELD, Senior Circuit Judge:

On its income tax return for the year ending October 2, 1970 Jack's Cookie Company ("Jack's") claimed a business expense deduction in the amount of $191,720.92 for cash disbursements made during that year under the terms of a written lease for an industrial building. The Internal Revenue Service disallowed $20,479.08 of the deduction, which had the result of reducing taxpayer's 1970 net operating loss and increasing by $9,829.96 Jack's tax liability for a prior year to which the 1970 loss had been carried back. Jack's paid the deficiency for the prior year, plus interest, and brought this action after a petition for a refund was denied. Upon stipulated facts and exhibits, the district court awarded summary judgment in favor of Jack's for the full amount of the deficiency and interest, holding that the partial

disallowance of the deduction claimed by Jack's in 1970 was in error. The Government appeals, and we reverse.

I

To finance the construction of a county-owned industrial building which Jack's Cookie Company agreed to lease for a term of 30 years, the County Court of Giles County, Tennessee, authorized two issues of interest-bearing bonds dated June 1, 1962, each in the principal amount of $1,250,000 and each to mature serially over the term of the lease. One issue consisted of "Industrial Building Revenue Bonds" ("revenue bonds"),[1] which are not general obligations of the county, the interest and principal being payable solely from revenues realized from the lease of the building. The other bonds, "Industrial Building Revenue and Tax Deficiency Bonds" ("tax deficiency bonds"),[2] are also retired from the rental income, but if proceeds under the lease should ever prove insufficient to meet the obligations to holders of these bonds, county tax levies are pledged to satisfy any deficiency. Repayment of both the revenue and tax deficiency bonds is ultimately secured by a June, 1962, indenture of mortgage and deed of trust between Giles County and a Memphis bank which serves as trustee for the bondholders.

To ensure that proceeds from the lease are always adequate to promptly service the bonds, the written lease agreement between Giles County and Jack's requires that the lessee pay to the county "monthly rentals," beginning no later than June 1, 1964,[3] in an amount equal to

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[1] *See* The Industrial Building Revenue Bond Act of 1951, TENN. CODE ANN. §§ 6-1701 to 1716.

[2] *See* The Industrial Building Bond Act of 1955, TENN. CODE ANN. §§ 6-2901 to 2916.

[3] The 30-year term of the lease began on June 1, 1962, but Jack's was required to pay no rent until the building was ready for occupancy or June 1, 1964, whichever came first. In the interim, a portion of the proceeds from the sale of bonds was used to pay interest to bondholders.

> "One-sixth (1/6) of the next semi-annual interest due on each of said bond issued, [sic] plus * * * one-twelfth (1/12) of the next principal payment due on each of said bond issues, plus all necessary and reasonable expenses incurred by the Trustee and Paying Agent in the Administration of said bond issues * * *."

To these three sums, which are geared to the repayment of the bonds, the agreement adds a fourth amount due each month through the fifteenth year of the lease as "rent"; the lessee is required to make what are termed "reserve payments" in equal monthly installments sufficient to total $285,000 by the end of the fifteenth year. If Jack's fails to timely pay any part of its monthly rent, including the reserve payment, the county has the right to cancel the lease unless arrears are cured within a specified time.

Monthly rentals are payable to the trustee bank, which is required by the indenture of mortgage to use all except the reserve payments portion to pay principal and interest as they come due on both types of bonds and to cover expenses incurred by the bank as trustee.[4] Expressly different treatment is afforded the reserve payment element of each monthly installment. Reserve payments may not be used to routinely service the bonds; instead, they must be accumulated by the trustee and expended only as follows:

> —if Jack's so directs, the trustee must invest reserve payments in obligations of the United States, returning any interest earned thereon to the reserve fund.

[4] So long as Jack's is currnet in its rental payments, as it was throughout the period relevant to this case, the first three elements used to calculate each month's rent will, by definition, ensure sufficient revenues to meet these needs.

> —if ever other monies are unavailable to pay interest and principal due on the revenue bonds, the trustee may use reserve funds for that purpose.[5]
>
> —if, as it is entitled to do anytime after the fifteenth year of the lease, Jack's elects to prepay all its remaining rent obligations (in an amount equal to all unpaid principal and interest on all bonds, plus call premiums), the funds then in the reserve are to be credited against the amount due.
>
> —if the rented premises are damaged or condemned, the lessee can opt not to have them reconstructed, in which case the lease will terminate upon prepayment of all remaining rental obligations, against which Jack's is to receive a credit for the funds then in the reserve.

All documents to which Jack's is a party are silent as to the disposition of the reserve funds in the unlikely event that any exist when the full term of the lease expires and all of the bonds have been retired.[6] However, language in a county court resolution which authorized the sale of revenue bonds suggests that the county might lay claim to any such surplus.[7]

In the year ending October 2, 1970, Jack's made monthly rental payments totalling $191,720.92 pursuant to the lease provisions set forth above. As heretofore stated, the Internal Revenue Service disallowed as a

[5] E.g., if Jack's defaults on its rent and if, while the default continues, interest or principal comes due on revenue bonds, then the trustee may dip into the reserves to satisfy the revenue bond holders.

[6] At oral argument, it was agreed that, assuming Jack's occupies the building for the full term of the lease, the lessee would be "economically foolish" not to prepay its rent at some time in order to get the full benefit of any reserves as a credit against future rent.

[7] Appendix at 99.

deduction for current business rental expense $20,479.08 of that amount, which was the amount of the "reserve payments" made during that year. The Government's position is that taxpayer's obligation to pay rent under the lease boils down to an obligation only to retire the outstanding bonds. Because the reserve payments, unlike the rest of each month's rent, were not used or geared to satisfy any actual bond obligations during the tax year in question, and because at the taxpayer's election they can be applied to that end at some future time, e.g., as a credit in the event of prepayment of rent, it is asserted that these expenditures were capital in nature and that Jack's may deduct them, not as current expenses in the year they were paid to the trustee, but rather only when the reserve fund is actually consumed for the lessee's benefit. In support of this view the Government points to cases which hold that security deposits or advance rents which a lessee is required to pay the lessor are deductible as rent only in the year or years *for which* they are paid as rent and in which they are applied toward satisfying the lessee's actual rent obligations, not in the year *in which* they are paid unless that year is also one to which the payments or portions thereof are considered applicable as rent.[8]

Challenging the disallowance, taxpayer argues that even though the reserve payments might benefit Jack's by fulfilling certain provisions of the lease beyond the tax year in issue, the lessee had no choice but to make the monthly payments into the reserve if it was to enjoy continued use of the industrial building during the tax year; failure to do so would have allowed the county to

[8] Citing *Kohler-Campbell Corp.* v. *United States*, 298 F.2d 911, 913 (4 Cir. 1962); *Commissioner* v. *Bolyston Market Ass'n.*, 131 F.2d 966 (1 Cir. 1942); *Galatoire Bros.* v. *Lines*, 23 F.2d 676 (5 Cir. 1928); *Smith* v. *Commisisoner*, 51 T.C. 429, 440 (1968); *Minneapolis Security Building Corp.* v. *Commissioner*, 38 B.T.A. 1220 (1938).

cancel the lease. Thus, it is contended, the payments constituted ordinary and necessary business rental expenses deductible in the year paid under the plain language of Section 162(a)(3) of the Internal Revenue Code, 26 U.S.C. § 162(a)(3), which reads:

> "(a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses *paid or incurred during the taxable year* in carrying on any trade or business, including—
>
> * * * *
>
> (3) *rentals* or other payments required to be made as a condition to the continued use or possession, *for purposes of the trade or business, of property* to which the taxpayer has not taken or is not taking title or in which he has no equity."

(Emphasis added).[9] Moreover, deduction of the reserve element of the rent in the year paid would comport with the company's own treatment of the expense for internal accounting purposes, and since this treatment of the expense allegedly more clearly reflects the company's true income for the tax year than if deduction is deferred to a later year, Jack's maintains that deduction of the reserve installments in the year they are made is also sanctioned by the Code's tax accounting guidelines.[10]

[9] The company, which insists that the expenditures in question were "rentals," disclaimed at oral argument any reliance upon the "or other payments" language of the statute. Also, neither party contends that Jack's has taken or is taking title to the leased premises, or that Jack's has any equity therein within the meaning of Section 162(a)(3). Upon expiration of the 30-year term of the lease on August 1, 1992, taxpayer has the option to renew for three additional terms of 10 years each.

[10] 26 U.S.C. § 446 provides that "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books," but

Taxpayer urges that the deduction be allowed and that any benefit which might be derived from the reserve fund in the future, such as a credit against prepaid rent, be taxed as income to Jack's in the year such benefit accrues.

In awarding the company a refund of the tax it had paid on account of the disallowed deduction,[11] the district court reasoned that the mandatory nature of the reserve payments entitled the taxpayer to deduct them in the year they were paid to the trustee:

> "It seems to me that the government has the better of the decided cases, but the taxpayer has the advantage on the text of the statute and on the common sense of this particular case. The taxpayer had no part in creating the shape of the payments nor the timing of them. There is no way it can get the land without making the payments as required. The payments are made now and are a necessary current expense. The taxpayer gets the use of the land now, and thus receives the value of the payments now. There has been no conniving. The excess payments and the interest on those payments will be taxable to the taxpayer when the money is released from escrow." [12]

We are of the opinion, however, that the propriety and timing of the deduction are governed by considerations other than the mandatory nature of the reserve payments

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that "[i]f the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income."

[11] The district court had jurisdiction of this action under 28 U.S.C. § 1346(a)(1), and venue was properly laid in the Western District of North Carolina because taxpayer maintained its principal place of business in that district. 28 U.S.C. § 1402(a)(2).

[12] *Jack's Cookie Company* v. *United States*, No. C-C-75-358 (W.D. N.C., June 3, 1977).

and that, applying those standards, the Government is entitled to summary judgment upon the undisputed facts as a matter of law.[13]

II

In computing taxable income, a business is authorized by Section 162(a)(3) of the Internal Revenue Code to deduct "rentals" from its gross income. Although the term "rentals" is not defined in the statute, as early as 1925 the Supreme Court recognized that the word is to be taken in its "usual and ordinary sense" to mean "a fixed sum, or property amounting to a fixed sum, to be paid at stated times for the use of property." *Duffy* v. *Central R.R.*, 268 U.S. 55, 63 (1925). This interpretation of "rentals," which has never been legislatively altered, has been consistently followed by the courts, although not without elaboration.

Notably, it has been firmly established as a result of litigation under § 162(a)(3) that, to qualify as a rental, a payment made to secure the use of business property must be "required" of the lessee, or, as put by one court, "wrung from [the lessee] by compulsion of circumstances delineated by law." *Utter-McKinley Mortuaries* v. *Commissioner*, 225 F.2d 870, 874 (9 Cir. 1955). As an essential attribute of rentals, the compulsion to pay is most often discussed in the context of contrived arrangements between lessors and lessees which have as their evident purpose the evasion of taxes,[14] but it is nevertheless a

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[13] Like the plaintiff, the Government moved for summary judgment in the district court.

[14] *E.g.*, *Sparks Nuggett, Inc.* v. *Commissioner*, 458 F.2d 631, 634 (9 Cir. 1972), *cert. denied*, 410 U.S. 928 (1973); *Potter Electric Signal and Mfg. Co.* v. *Commissioner*, 286 F.2d 200, 202-203 (8 Cir. 1961); *Kirschenmann* v. *Westover*, 225 F.2d 69 (9 Cir. 1955), *cert. denied*, 350 U.S. 834 (1955); *Smith* v. *United States*, 278 F.Supp. 230, 232 (S.D. Tex. 1968); *E-Z Sew Enterprises, Inc.* v. *United States*, 260 F.Supp. 100, 118-119 (E.D. Mich. 1966). There is no suggestion that the "reserve payments" provision of the lease be-

characteristic which, as a common sense matter, any claimed "rental" expenditure must possess if it is to be treated as such for purposes of an expense deduction. To hold otherwise would be to invite the deduction as rent of sums which are not truly paid "for the use of property," in contravention of the settled principle that statutes authorizing deductions from income for federal tax purposes are to be strictly construed. *See Koerner* v. *United States*, 550 F.2d 1362 (4 Cir. 1977), *cert. denied*, 434 U.S. 984 (1977). Thus, unless a taxpayer is under an obligation to compensate another in return for the use of property for business purposes, the disbursement is not a "rental" under § 162(a)(3).

The same is true of the "other payments" related to the lease of property for which deductions are authorized by this section of the Code—payments "*ejusdem generis* with 'rentals,' such as taxes, insurance, interest on mortgages, and the like, constituting liabilities of the lessor on account of the leased premises which the lessee has covenanted to pay." *Duffy* v. *Central R.R.*, *supra*, 268 U.S. at 64. In express terms, the statute allows a taxpayer to subtract such outlays in arriving at taxable income only if they are "required to be made as a condition to the continued use or possession" of the property.

But although an "obligation to pay" must exist before a business will be allowed to deduct a lease-related payment under § 162(a)(3), it does not follow that all expenditures which a business is compelled to make in order to secure the use of property constitute "rentals" or "other payments," or that those which facially qualify as such are deductible in the year paid. That a business

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tween Jack's and the county was contrived. Indeed, the county may have been bound by state law to establish some sort of reserve in light of the issuance of revenue bonds. *See* TENN. CODE ANN. §§ 6-1704(4), 1715.

is "required" to incur an expense to avoid cancellation of a lease, or as the court below stated, that "[t]here is no way [the taxpayer] can get the land without making the payments as required," goes only to the threshold factual question of whether the expenditure is of the sort contemplated by subsection (3) of § 162(a), and it is not dispositive of that issue, since there are other characteristics which a disbursement must have if it is to be treated as a "rental" or "other payment" within the meaning of the statute. Moreover, once it is determined that an expenditure *is* by nature a "rental" or "other payment," and the inquiry then turns to the matter of *when* a 162(a)(3) deduction in that amount may be taken, the fact that a taxpayer was "required" by the lease to pay the sum at a particular time is of less significance and does not of itself warrant allowance of the deduction in any particular year.

Not often advanced in explicit terms, these principles are plain from the face of the "decided cases" referred to in the opinion below. If it were true, for example, that by reason of their mandatory nature all payments extracted by contract as a condition to occupying another's property qualify as "rentals" or "other payments" under § 162(a)(3), then one would expect that a "security deposit" paid by a business as a prerequisite to possession of premises, and sums periodically paid to continue the possession, would be uniformly treated as such. Yet as the decision in *Minneapolis Security Building Corp.* v. *Commissioner*, 38 B.T.A. 1220, 1224 (1938), demonstrates, such status may be denied a security deposit which a business is "required" to pay at the outset of a lease, and the cases are legion which on various grounds have refused to treat as statutory "rentals" or "other payments," installments, though labelled "rent," remitted to the owner of property by a taxpayer business in fulfillment of the strict terms of a written lease. *E.g.*,

Duffy v. *Central R.R.*, *supra*, 268 U.S. 55 (rejecting the argument that any payments under a lease, the failure to make which would entitle the landowner to terminate the possession of the property, constitute "rentals" under the statute); *Foyt* v. *United States*, 561 F.2d 599 (5 Cir. 1977) (monthly "rental payments" were in fact contributions to capital, not rentals); *M & W Gear Co.* v *Commissioner*, 446 F.2d 841 (7 Cir. 1971) (claimed "rentals" held instead to be partial payments on purchase price); *West Virginia Northern R. Co.* v. *Commissioner*, 282 F.2d 63 (4 Cir. 1960), *cert. denied*, 366 U.S. 929 (1961) (sums designated "rentals" by lease were actually payments in satisfaction of personal debt). Obviously, something more than the compulsory nature of a disbursement determines whether or not it qualifies for deduction under the statute.

Similarly, a "requirement to pay" cannot explain the results in cases where the issue has been the *timing* of deductions for sums which *do* qualify as "rentals" or "other payments." Although incurred in each instance pursuant to contract, some costs of this kind—like the elements of plaintiff's rent which are defined in terms of principal, interest, and administration expenses—are commonly allowed as deductions in the year they fall due, while others, notably "advance" or "prepaid" rentals, are often allowed as deductions only in or over some later period.[15] For cases of the latter kind, *see* n. 8, *supra*. The only legitimate explanation for these differences is that the matter of when a deduction may be claimed under § 162(a)(3) is not determined solely on the basis of whether, under threat of penalty or dispossession, the lessee was bound to remunerate the lessor in a given amount on a certain date. The pertinent inquiry is of wider scope.

[15] Advance rentals may be so treated regardless of whether the lessee reports deductions on an accrual or a cash basis. *Williamson* v. *Commissioner*, 37 T.C. 941, 943 (1962).

We conclude, therefore, that the brief rationale offered by the court below does not sustain the judgment on appeal. To qualify for a current deduction under § 162(a)(3) of the Code, it is necessary, but not sufficient, that an outlay made during the tax year was "required" of the lessee as a condition to occupancy of the premises. While Jack's no doubt would have risked cancellation of the lease had it not timely forwarded the "reserve payment" portion of the monthly installments to the trustee, this circumstance satisfies only one element of the claim for relief, and is not, in itself, dispositive under either the taxpayer's or the Government's theory of the case.

III

The question of whether Jack's was entitled to a current deduction for the "reserve element" of the monthly payments involves two closely related features of the revenue laws. First, the Code draws a distinction between various kinds of expenditures for the purpose of determining their tax treatment. Different statutory provisions, for example, govern the manner in which "trade or business expenses", on the one hand, and "capital expenditures", on the other, may be charged by the taxpayer against gross income. The initial inquiry concerns the nature of the cost incurred by the company; were the payments into the reserve fund trade or business expenses, were they capital in nature, or were they something else? Once the payments are so categorized, the focus shifts to the guidelines which specify whether, when, and in what amount disbursements of that kind may be reflected in the calculation of taxable income. The ultimate question is whether the applicable rules sanction, in the year they were incurred, a deduction in full for costs of the type in dispute.

Cast in these terms, the disagreement between the taxpayer and the Government involves only the first stage of

the inquiry. The company argues that the reserve payments were "rentals", a species of the "trade or business expenses" made deductible by § 162(a),[16] while the Government maintains that the expenditures were instead "capital in nature". Apart from this controversy as to the nature of the disbursements, neither party disputes the consequences which would follow if the opponent's characterization of the payments were to prevail. The Government concedes that if they truly were trade or business expenses within the meaning of § 162(a), then the reserve increments of the monthly outlays were deductible in the year paid and Jack's was entitled to the claimed deduction.[17] For its part, taxpayer acquiesces in

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[16] It is suggested in taxpayer's brief on appeal that if an expenditure meets the definition of "rental" for purposes of subsection (3) of § 162(a), then it need not also possess the characteristics of a "trade or business expense" under § 162(a) in order to constitute a deductible expense under § 162. *See* Brief of Appellee at 12, 17-18. However, the plain language of the statute refutes this argument, and we note that the courts have not observed this distinction. Deductions claimed for "rentals" often have been disallowed on the basis that the expenditures in question failed to pass muster under § 162(a). *See, e.g., Foyt* v. *United States*, 561 F.2d 599 (5 Cir. 1977); *Perry* v. *United States*, 520 F.2d 235 (4 Cir. 1975), *cert. denied*, 423 U.S. 1052 (1976). Moreover, in recognizing and relying upon the notion that a sum must be "paid or incurred during the taxable year" in order to be treated as a "rental," Brief at 6, even the appellee acknowledges that § 162(a)(3) rentals must meet a requirement that is found only in § 162(a). Accordingly, we view the taxpayer's position to necessarily be that the reserve payments qualified as deductible expenses not only because they satisfied the specific conditions which any "rental" must meet under § 162(a)(3), but also because they met the basic tests of a § 162(a) trade or business expense, of which "rentals" are but one variety.

[17] 26 U.S.C. § 461(a) provides that a deduction for a § 161(a) trade or business expense "shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income." The "method of accounting used in computing taxable income" is the method "on the basis of which the taxpayer regularly computes his income in keeping his books," unless the taxpayer's accounting method is challenged by

the Government's position that if found to be "capital in nature", the expenditures were not deductible in the year paid, but rather may be used to reduce the company's taxable income, if at all, only in some later year or years when the reserve fund is actually applied in some manner beneficial to the taxpayer.[18]

The issue to be resolved is not an unfamiliar one for on prior occasions we have been called upon to determine into which category various expenditures should appropriately be placed.

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the Secretary on the basis that it does not "clearly reflect income." 26 U.S.C. §§ 446(a), (b). *See* n. 10, *supra*. The Government admits that for internal accounting purposes, Jack's treats as current rent expense the full amount it paid under the lease, Brief of Appellant at 7, and, except on the ground that the reserve payments were "capital expenditures" not governed by § 461(a), the Government does not challenge under § 446(b) this treatment of the disbursements.

[18] This treatment of the expenditures follows from the principle that "[c]apital expenditures * * * if deductible at all, must be amortized over the useful life of the asset," *Commissioner* v. *Tellier*, 383 U.S. 687, 689-690 (1966), and is akin to the treatment afforded "advance rentals" which, once they are recognized as "capital expenditures," may be subtracted in arriving at taxable income only in the year or years in which they are actually used to displace rental payments that the lessee would otherwise have to make during those periods under the lease. Although "an expenditure need not be for a capital asset, as described in Section 1221 of the Code, 26 U.S.C. § 1221, in order to be classified as a capital expenditure," *Georator Corp.* v. *United States*, 485 F.2d 283, 285 (4 Cir. 1973), *cert. denied*, 417 U.S. 945 (1974), "the reason for disallowing the deduction of the entire payment or obligation in the taxable year is that there is no provision which permits deduction [of a capital expenditure] other than that which allows depreciation or amortization over the useful life of the asset acquired." 2 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 12.24 (1974 Revision). *See* 26 U.S.C. § 167. Appellee's reliance upon 26 U.S.C. § 461(a) to avoid this result is misplaced, since § 461(a) does not govern the timing of deductions for disbursements of a capital nature.

A

Mindful that "[o]ur system of income taxation attempts to match income and expenses of the taxable year so as to tax only net income," in *Richmond Television Corp.* v. *United States*, 345 F.2d 901, 907 (4 Cir. 1965),[19] we embraced the "one-year" rule then followed by the Tenth Circuit, which treats an item as either a business expense, fully deductible in the year paid, or a capital expenditure, which is not, depending upon whether it secures for the taxpayer a business advantage which will be exhausted completely within the tax year.

> "[A]n expenditure should be treated as one in the nature of a capital outlay if it brings about the acquisition of an asset having a period of useful life in excess of one year, or if it secures a like advantage to the taxpayer which has a life of more than one year."

345 F.2d at 907.[20] In applying the rule in that case, we denied a current deduction for business expense to a taxpayer which had spent $25,000 to acquire a staff of trained employees from another corporation:

> "A taxpayer may, therefore, not deduct as a current business expense the full cost of acquiring an asset, tangible or intangible, which benefits the taxpayer for more than one year. * * *
>
> "* * * This was in all regards the acquisition of a capital asset whose value to the taxpayer would continue for many years, even though from time to time individual staff members could be expected to leave its employ."

[19] *Vacated and remanded on other grounds*, 382 U.S. 68 (1965), *on remand*, 354 F.2d 410 (4 Cir. 1965).

[20] Quoting *United States* v. *Akin*, 248 F.2d 742, 744 (10 Cir. 1957).

The one-year concept surfaced again in *Darlington-Hartsville Coca-Cola Bottling Co.* v. *United States*, 393 F.2d 494 (4 Cir. 1968), *cert. denied*, 393 U.S. 962 (1968). There the taxpayer bottling companies deducted in one year, as an ordinary and necessary business expense under § 162(a), amounts they had paid the owner of a soft drink franchise to eliminate a middleman syrup distributor. Elimination of the middleman reduced the price of syrup to the bottlers, and there was every indication that the taxpayers would enjoy this more profitable arrangement in future years at no additional cost. Citing *Richmond Television*, the district court upheld the Commissioner's determination that the amounts spent to acquire the new syrup contracts were capital investments despite the fact that the contracts were not physical assets in the technical sense.[21] We adopted the opinion of the lower court with the observation that a capital expenditure is marked by "its intendment to produce a positive business benefit whose effects will be reaped in seasons beyond a single year." 393 F.2d at 496.

We last applied the one-year rule as an alterantive ground for our decision in *Georator Corp.* v. *United States*, 485 F.2d 283 (4 Cir. 1973), *cert. denied*, 417 U.S. 945 (1974). In *Georator*, which concerned the tax treatment of legal fees incurred by a corporation in successfully resisting the cancellation of a trademark registration, we stated that

> "[o]ur analysis of this question begins with the principle of taxation reflected in Section 162(a) of the Internal Revenue Code that an expenditure securing benefits which are realized and exhausted in the same tax period is fully deductible in that tax

[21] *Darlington-Hartsville Coca-Cola Bottling Co.* v. *United States*, 273 F.Supp. 229 (D.S.C. 1967).

> period. Conversely, an expenditure securing benefits beyond the taxable year must be capitalized." [22]

485 F.2d at 284. Because "the benefits of successful opposition to the cancellation petition were likely to extend, and in fact did extend, beyond the tax period in which they were secured," 485 F.2d at 285, we concluded that the legal fees should be capitalized even though they were not among the expenditures expressly designated as capital assets in § 1221 of the Internal Revenue Code.

The taxpayer suggests that under our recent decision in *First National Bank of South Carolina* v. *United States*, 558 F.2d 721 (4 Cir. 1977) (per curiam), the one-year rule of our prior decisions has been replaced by a new test in this area. In making this argument the taxpayer points out that the opinion in that case makes no mention of the one-year rule and cites none of the foregoing cases. The Government, on the other hand, contends that the one-year principle survived *First Bank* and that, at most, the decision established only an alternative test which need not be applied in every case. In our opinion, *First Bank* did not abrogate the rule followed in our prior decisions, but merely refined and made explicit certain limitations which have always been inherent in its application.

At issue in *First Bank* was the tax status of assessments paid by a bank to a non-profit association which was established by a number of banks to operate a computerized system for recording, authorizing, and billing the credit card transactions of their customers. The joint venture was undertaken to avoid duplication of costs and achieve economies of scale. As a member of the association, the taxpayer bank owned no stock, had no interest in the organization's assets, and was not entitled to any

[22] Citing the *Darlington-Hartsville* and *Richmond Television* cases.

distribution of profits. Membership was non-transferable, and upon dissolution, the assets of the association were to be paid over to a tax-exempt charity.

The assessments in question were all paid by the bank to cover expenses incurred in the association's formative state—salaries, office and equipment rental, general office expenses, advertising fees, and consultant's costs. Once operational, the association met expenses by charging each member bank a certain amount for each new credit card issued. Taxpayer sought to deduct the pre-operational assessments as an ordinary and necessary business expense under § 162(a), but the Commissioner disallowed the deduction on the theory that the payments were membership fees in the nature of capital expenditures because the benefit to the bank for which the assessments were incurred would extend indefinitely into future years.

Agreeing with the bank in its action for a refund, the district court noted, but did not rely upon, the one-year rule. Instead, it considered the facts of the case in the light of language from the Supreme Court's opinion in *Commissioner* v. *Lincoln Savings and Loan Association*, 403 U.S. 345 (1971):

> "[T]he presence of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year.
>
> "What is important and controlling, we feel, is that the § 404(d) payment serves to create or enhance for Lincoln what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under § 162(a) in the absence of other factors not established here."

403 U.S. at 354, quoted in 413 F.Supp. 1107, 1111 (D.S.C. 1976). Since the taxpayer's membership in the association was non-transferrable and, therefore, of no intrinsic value, with the result that the bank had no salable asset from which it could recoup its assessments, the district judge concluded that the assessments could not be regarded as creating for the bank "anything remotely similar to the 'distinct and recognized property interest' which the Court in *Lincoln Savings* found that the taxpayer had acquired." *Id.*

On appeal, we affirmed on the opinion of the district judge and referred to the above quotation from *Lincoln Savings* as the standard by which capital expenditures are to be distinguished from ordinary expenses. 558 F.2d at 723. While our *per curiam* opinion omitted any reference to the one-year rule, it did describe as "indistinguishable from the case at bar" the case of *Colorado Springs National Bank* v. *United States*, 505 F.2d 1185 (10 Cir. 1974). There, in light of *Lincoln Savings*, the Tenth Circuit, from which we imported the one-year rule, observed that the rule "was intended to serve *as a mere guidepost* for the resolution of the ultimate issue, not as an absolute rule requiring the automatic capitalization of every expenditure providing the taxpayer with a benefit enduring for a period in excess of one year." 505 F.2d at 1192 (emphasis added).

This, we think, explains any facial conflict there may seem to be between *First Bank* and our earlier decisions. While the one-year concept has been the focal point of controversy and decision in several cases, the rule is not, in itself, talismanic and we have never so held. In the abstract many costs incurred by an on-going business can be viewed as producing some type of benefit beyond the taxable year, but we have never indicated that capitalization of an item is required on that basis alone. *First Bank* is a case in point. The bank's contribution

helped to launch the association which, once established, rendered a cost-saving service to the bank in subsequent years; in this sense the pre-operational assessments would have a future impact. They, nonetheless, were deemed fully deductible in the year incurred.

But this is not to say that the potential of an expenditure to produce a business advantage over and beyond the tax year is irrelevant. To the contrary, unless an expenditure which would otherwise be treated as a Section 162(a) business expense results in benefits which are not realized and exhausted within the taxable year, its capitalization would be inappropriate in any event. A business cost must produce a benefit that will extend into future years if it is to be capitalized. Yet, that fact alone is insufficient to *require* such treatment. The one-year rule is useful because it serves to segregate from all business costs those which cannot possibly be considered capital in nature because of their transitory utility to the taxpayer. The rule, however, cannot be applied inexorably in the other direction.

It is apparent that the "separate assets" test of *Lincoln Savings*, which was followed in *First Bank*, necessarily incorporates the one-year rule and that in order to warrant capitalization of an expense, one integral characteristic of the "separate and distinct asset" which is "created or enhanced" by the outlay, is that it will serve the taxpayer in subsequent years.[23] Unquestionably the rule was refined by the language of *Lincoln Savings* which cautions that the "future benefit" aspect of capitalized costs should not be emphasized or applied to the exclusion of other essential features which it identifies generally as those possessed by "assets". In this light, the significance of our failure in *First Bank* to even mention the one-year

[23] The expenditures which were found to be capital in nature in *Lincoln Savings* were of potential benefit to the taxpayer beyond the taxable year.

rule is that its application was unnecessary because the assessments in issue were found to lack another characteristic of equal moment under the "separate assets" test, i.e., they did not create for the bank a property interest in anything of intrinsic or salable value.[24]

In the light of these underlying considerations, it is necessary to determine how the taxpayer's claim fares under the test of *Lincoln Savings.*

B

Although Jack's had to pay the reserve element of its monthly rents to continue in possession of the property, and in that sense the payments were of current consequence to the company, there is no doubt that the disbursements also secured to the taxpayer benefits having a useful life which extended substantially beyond the close of the taxable year. This is clear from the indenture of mortgage, which requires that the trustee credit Jack's with the amount in the reserve fund in the event of prepayment of rent, and that the trustee return to the fund any interest earned on the investment of the reserves, thereby increasing the size of this credit. The taxpayer makes the point that Jack's might default on the lease or that other circumstances might arise to prevent Jack's from receiving the benefit of the reserve,

[24] The district court in *First Bank* discerned no inconsistency between its disposition of that case and our decision in *Georator*, stating:

> "* * * however, the Court [in *Georator*] assumed the existence of a definite asset, the trademark, and * * * [dismissed] taxpayer's argument that its legal fees should not be capitalized because they only maintained and did not enhance the value of the trademark. *Georator* was correctly decided, but it is not inconsistent with the result in this case, where neither party can identify or define any asset upon which taxpayer's assessment expenditures have had any effect."

First Nat. Bank of South Carolina v. *United States*, 413 F.Supp. 1107, 1112 (D. S.C. 1976).

but we do not see that this possibility requires treatment of the payments as § 162(a) expenses. A similar argument was advanced by the taxpayer in *Lincoln Savings*, but the Court rejected it with the observation that "this hazard exists with any routine investment in a bank or an insurance company and yet its presence does not make that investment an expense rather than a capital undertaking." 403 U.S. at 357.

Moreover, measured by the standard of *First Bank*, the fund into which the reserve element of the rents was paid was essentially a "separate and distinct asset" which must be capitalized. As Plaintiff's Exhibit 4, App. 85, suggests, the reserve fund had an ascertainable and real value to the taxpayer in an amount equal to the sum of the reserve payments plus any investment income earned thereon. Together with the taxpayer's exclusive right to direct that the fund be invested and the fact that the reserve would rebound to the benefit of Jack's if and when it chose to prepay rent, this establishes the requisite "property interest" in the account. Taxpayer would have us reach a contrary conclusion because in its view the reserve belonged exclusively to the county at the close of the tax year. This, however, ignores the power retained by the taxpayer to direct the trustee to invest the reserves, as well as the plain language of the indenture of mortgage which suggests that the fund will finally be paid out only upon the occurrence of the contingencies therein set forth.

In *Lincoln Savings* the Court found that the reserve account into which the payment flowed was essentially a separate asset because it was "available for only stated and circumscribed purposes", because it was "more permanent than temporary", and because the taxpayer had a "distinct and recognized property interest" therein (interest earned on FSLIC's investment of taxpayer's contributions was credited to taxpayer's share of the

reserve). 403 U.S. at 355-356; the same can be said of the reserve into which the disputed portion of Jack's monthly installments was paid. There, as here, the reserve into which the taxpayer paid premiums was statutorily mandated, but the Court noted that "the fact that a payment is imposed compulsorily upon a taxpayer does not in and of itself make the payment an ordinary and necessary expense within the meaning of § 162(a) of the 1954 Code." 403 U.S. at 359. There, too, it was unlikely that the taxpayer would ever recover its payments, but the Court deemed this fact of little significance and found that the bank could nonetheless benefit from its expenditure in the future. 403 U.S. at 357. There the taxpayer, like Jack's, interposed the annual accounting concept of the income tax as a factor which required that a current deduction be allowed, but the Court viewed that argument as having little bearing upon "the determination of whether an item is or is not an ordinary expense." 403 U.S. at 358. On balance, there is little of significance to distinguish the two cases, and we discern nothing in *Lincoln Savings* which would entitle Jack's to a current deduction.

Under the appropriate tests, we conclude that Jack's was not entitled to the deduction claimed by it under § 162(a). Accordingly, the judgment of the district court is reversed and the case is remanded for entry of judgment in favor of the Government.

REVERSED and *REMANDED.*

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 77-2210

JACK'S COOKIE COMPANY,
Appellee

v.

THE UNITED STATES OF AMERICA,
Appellant

Appeal from the United States District Court for the Western District of North Carolina, at Charlotte
James B. McMillan, District Judge

(Filed and entered April 25, 1979)

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the Western District of North Carolina, and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this Court that the judgment of the said District Court appealed from, in this cause, be, and the same is hereby, reversed. The case is remanded to the United States District Court for the Western District of North Carolina, at Charlotte, for entry of judgment in favor of the Government consistent with the opinion of this Court filed herewith.

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 77-2210

JACK'S COOKIE COMPANY,
Appellee,

versus

THE UNITED STATES OF AMERICA,
Appellant.

Appeal from the United States District Court for the Western District of North Carolina, at Charlotte
James B. McMillan, District Judge

(Filed May 29, 1979)

Upon consideration of a motion of the appellee, by counsel, for stay of mandate pending application to the United States Supreme Court for a writ of certiorari,

IT IS ORDERED that the motion is DENIED.

For the Court—by Direction

/s/ William K. Slate, II
Clerk

APPENDIX E

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 162. TRADE OR BUSINESS EXPENSES

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

* * * *

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

Sec. 446. GENERAL RULE FOR METHODS OF ACCOUNTING

(a) *General Rule.*—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) *Exceptions.*—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

* * * *

Tennessee Code Annotated (1970 Supp.)

Sec. 6-1704. Powers of municipalities

In addition to powers which it may now have, any municipality shall have power under this chapter:

* * * *

(2) To issue its bonds to finance in whole or in part the cost of the acquisition, purchase, construction, reconstrution, improvement, betterment or extension of any industrial building. The governing body of the municipality in determining such cost may include all cost and estimated cost of the issuance of said bonds, all engineering, inspection, fiscal and legal expenses, and interest which it is estimated will accrue during the construction period and for six (6) months thereafter on money borrowed or which it is estimated will be borrowed pursuant to this chapter.

(3) To rent or lease such industrial buildings to industrial or commercial concerns in such manner that rents to be charged for the use of the industrial buildings shall be fixed and revised from time to time so as to produce income and revenues sufficient to provide for the prompt payment of interest upon all bonds issued hereunder and to create a sinking fund to pay the principal of such bonds when due.

* * * *

Sec. 6-1715. Rentals sufficient to pay bonds.

The governing body of a municipality issuing bonds pursuant to this chapter shall prescribe and collect rentals for industrial buildings and shall revise same from time to time whenever necessary so that the income and revenues to be derived from such rentals will always be sufficient to pay when due all bonds and interest thereon for the payment of which such revenues are pledged, including reserves therefor.

APPENDIX F

LEASE

THIS INDENTURE OF LEASE made and entered into as of the 1st day of June 1962, by and between the County of Giles, Tennessee, (County) and Jack's Cookie Corporation, a corporation organized and existing under and by virtue of the laws of the State of Ohio, with its principal office in the City of Charlotte, North Carolina (Company).

WITNESSETH

That the County does hereby lease to the Company and the Company hereby rents from the County upon the terms and conditions hereinafter set forth, the following described real estate with the Industrial Building agreed to be constructed thereon in accordance with the plans and specifications of the Company and all easements and appurtenances thereunto belonging or in any wise appertaining, together with such machinery for the operation of a manufacturing plant as shall be specified by the Company and installed in said building. Said real property is described as follows:

(description omitted)

* * * *

3. The *term* of this lease shall begin on the 1st day of June 1962, and shall continue for a period ending August 1, 1992 unless sooner terminated under the provisions of Sections 13, 14, 17 and 18 hereof; however, rental shall not begin until the Company shall be placed in possession of the building and the machinery installed and operative.

The County hereby grants to the Company an *option to renew* or extend this lease for three (3) additional ten (10) year terms in the maximum number of thirty (30)

years commencing at the expiration of the lease, for an annual rental equivalent to taxes that would be levied by the County against said premises were the same taxable but not to exceed $12,000, and under the same terms and conditions, other than the amount of rentals, as provided herein. Failure of the Company to give the County written notice of at least sixty (60) days in advance of the expiration of the original terms or any ten year additional term of an intent to terminate this lease shall be conclusive evidence that the Company has elected to renew this lease for such additional ten year term; but provided that if the Company shall remain a tenant at the conclusion of the third renewal term, and without having given the required notice of an intent to terminate, the lease shall thereafter continue in like fashion as before on a year to year basis, *subject however to termination by either party by written notice one hundred and twenty (120) days prior to the end of the final ten year renewal or any annual period thereafter.*

4. So long as any of the bonds are oustanding, the Company binds itself to pay the County monthly rentals each month, beginning when the Company shall be put in possession of the building and all said machinery is installed and operable, but in no event later than June 1, 1964 and ending thirty (30) years from the date of the bonds, such monthly payments to be equal to:

One-sixth (1/6) of the next semi-annual interest due on each of said bond issues, plus, commencing with the payment for July 1964, one-twelfth (1/12) of the next principal payment due on each of said bond issues, plus all necessary and reasonable expenses incurred by the Trustee and Paying Agent in the Administration of said bond issues, plus an aggregate sum of Two Hundred and Eighty-Five Thousand Dollars ($285,000) payable in equal monthly installments beginning upon occupancy of the premises by the Company and terminating fifteen

(15) years after date of the bonds, as Reserve Payments into "Bond Fund Number One," as defined in Section 5 hereof.

At any time after fifteen (15) years from the date of said bonds, the Company shall have the option of prepaying all of its remaining rental payments by depositing with the Trustee "all prepaid installments of rent" as defined in Section 5 hereof.

5. All rental payments shall be due and payable on the first day of each month.

For the purposes of definition as hereinafter referred to, the term "all unpaid installments of rent" shall mean an amount equal to the entire principal amount of then oustanding bonds of both issues, together with all interest accrued and to accrue on and prior to the next succeeding call date of such bonds, and together with any call premiums required but deducting from such amount the aggregate amount then on deposit in the "Industrial Building" Revenue Bond and Interest Redemption Fund" (sometimes called "Bond Fund Number One") and in the "Industrial Building Revenue and Tax Deficiency Bond and Interest Redemption Fund" created by the resolutions of June 21, 1962, authorizing said bonds.

* * * *

9. The Company agrees that during the term of this lease it will keep the leased premises and all the buildings and improvements thereon and the appurtenances thereto in good repair at its sole cost, and to pay all taxes lawfully levied against said property, and upon the expiration of or termination of this lease, it will surrender the leased premises and the improvements thereon and appurtenances thereto unto the County in as good condition as prevailed at the time it was put in full possession thereof, excepting, however, ordinary wear and tear, war damage, and damage, destruction or loss under the con-

ditions provided in Sections 13 and 14 hereof. In the event that any part of the building or improvements thereon and appurtenances thereto require replacement during the term of this lease, the Company agrees to bear the cost of such replacement unless it shall have paid all rentals in advance pursuant to Sections 13 and 14 hereof, provided, however, that any amount collected by the Trustee under the aforesaid Indenture of Mortgage and Deed of Trust under any insurance policy for casualty or otherwise covering the cause for such replacement, shall be paid over to the Company pursuant to the terms of said Indenture of Mortgage or Deed or Trust.

* * * *

13. In the event of damage to or destruction of the Industrial Building situated on the leased premises there shall be no abatement or reduction in the rent payable by the Company to the County, and the Company shall repair or restore or reconstruct such building or construct a new building or buildings suitable for the needs and use of the Company as it may elect. In such events the Company shall be entitled to receive all money received as proceeds of any insurance carried on such Industrial Building, either upon completion of such repair, reconstruction or construction or periodically as such repair, reconstruction or construction progresses (but limited to the extent of the then cost of such reconstruction or construction) as the Company may elect, such payments to be applied by the Company to the payment of such cost of repair, construction or reconstruction or, if such cost has already been paid by the Company, to reimburse it for such cost; provided however, that the aggregate sum or sums so received by the Company shall in no event exceed the cost for such reconstruction.

Any surplus insurance proceeds after such repair, reconstruction has been completed and paid for shall be deposited in the Bond Fund in an amount not exceeding all unpaid installments of rent as defined in Section 5

hereof. The Company shall be entitled to any surplus thereafter remaining.

* * * *

In lieu of the obligation as hereinafter set forth in this section hereof to repair and restore or to reconstruct or replace the Industrial Building, the Company may pay in advance all unpaid installments of rent due hereunder in the amount provided in Section 5 hereof, and if such advance rental payment shall be in the full amount required by said Section 5 the Company shall not be required to repair and restore or to reconstruct or replace such damaged or destroyed Industrial Building and this lease shall, at the Option of the Company, cease and terminate. If in such event the insurance proceeds shall exceed such unpaid installments of rent the Company shall be entitled to any surplus as compensation for the loss of the use of the Industrial Building.

* * * *

14. If the whole of or any part of the leased premises shall be taken or condemned by any competent authority for any public or quasi-public use or purpose, then and in that event, the net proceeds of the award or compensation or damages recovered on account of any such taking or condemnation, after deducting any expense including counsel fees incurred by the County in litigating, arbitrating, compromising or settling any claim arising out of such condemnation, shall be disposed of in the following manner:

(a) If such taking or condemnation shall involve the taking or condemnation in whole of the leased premises or the taking or condemnation thereof in part to such extent that said premises are, in the sole judgment of the Company, thereby rendered unsuitable for economical usage by the Company, there shall be, on account of such taking or condemnation, no abatement or reduction in the rent payable by the Company to the County during the term

of this lease; and the Company, at its own cost shall, if same can lawfully be done, repair and restore the leased premises, in the event of such partial taking or condemnation; or reconstruct the Industrial Building or construct a new building or buildings suitable for the needs and use of the Company, as it may elect, in the event said leased premises be wholly taken or condemned or taken or condemned to such extent as to render said premises unsuitable for such economical usage; but the net proceeds of such award or compensation or damages recovered on account of said taking or condemnation shall be paid over to the Company, at Company's election, either upon the completion of such repairs and restoration or of such reconstruction or construction, or periodically as such repairs and restoration or such reconstruction or construction progress (but limited to the extent of the then cost of same), and be applied by the Company to the payment of the cost thereof or, if such cost has already been paid by the Company, to reimburse it for such cost; provided, however, that the actual cost of such repairs and restoration or of such reconstruction or construction.

Any surplus of the net award or compensation or damages remaining after the completion of and payment for such repairs and restoration or such reconstruction or construction shall be deposited in the Bond Fund; but if such surplus shall exceed all unpaid installments of rent as defined in Section 5 hereof, then the Company shall be entitled to the excess of such surplus.

In the event the Company shall fail to repair and restore or to reconstruct or to replace and pay the costs of repairing and restoring or of reconstructing or replacing the leased premises, as it is obligated by this sub-section (a) hereof to do, after the lapse of a reasonable time and after due notice given by the County to the Company the County may repair and restore or reconstruct said

leased premises and recover the reasonable cost thereof from the Company, less the net proceeds of such award or compensation.

Notwithstanding anything to the contrary that may be hereinbefore provided in this sub-section (a) hereof, in the event the Industrial Building cannot lawfully be repaired and restored or reconstructed, or in the event said Industrial Building cannot lawfully be replaced by a new building or buildings, as hereinbefore in this sub-section (a) is required or permitted to be done, or if by any reason of the reduction in the size, shape, or dimensions of the leased premises or for any reason otherwise it shall not, in the sole judgment of the Company be economically feasible and practicable to repair and restore or reconstruct said Industrial Building or to replace such Industrial Building with such new building or buildings so that same will be sufficient for the then needs of and use of the Company, then the Company shall not be required and the County shall not be entitled to repair or restore or reconstruct or replace the leased premises as hereinbefore in this sub-section (a) hereof provided; and then the net proceeds of such award or compensation or damages recovered on account of such taking or condemnation, when collected or received, shall be deposited in the Bond Fund. In the event the net proceeds of such award or compensation or damages on the date the same is collected or received shall exceed all unpaid installments of rent as defined in Section 5 hereof, then and in that event, there shall be deposited in the Bond Fund from such net proceeds an amount equal to the amount of such unpaid installments of rent, and the Company shall be entitled to, and the surplus of such net proceeds shall be paid over to the Company, and provided that if the net proceeds as deposited in the Bond Fund does not equal the amount of such unpaid installments of rent the Company shall pay the required rentals in advance, being the sum equal to the difference between the net proceeds and the

unpaid installments of rent, as defined in Section 5. Upon the payment of the required rentals this lease, at the sole option of the Company, shall cease and terminate.

(b) If such taking or condemnation shall not in the sole judgment of the Company, render the leased premises unsuitable for economic usage by the Company, then the net proceeds of the award or compensation or damages recovered on account of such taking or condemnation, when collected or received, shall be deposited in the Bond Fund. In the event the net proceeds of such award or compensation or damages on the date same is collected or received shall exceed all unpaid installments of rent as defined in Section 5, hereof, then, and in that event, there shall be deposited in the Bond Fund from such net proceeds and amount equal to the amount of such unpaid installments of rent, and the Company shall be entitled to, and the surplus of such net proceeds shall be paid over to the Company.

* * * *

17. It is made a condition of this lease that if the Company shall fail to pay any one or more monthly rental installments or any part thereof the County, at its option, may cancel and terminate this lease upon giving the Company written notice of such election within the time hereafter provided, which notice may be deposited in the United States mail and addressed to the President of the Company at its principal office in Charlotte, North Carolina; provided, however, that within the respective periods of 30 and 90 days from the receipt of said notice, as hereinafter provided, the Company shall have the privilege of paying the County all accrued and unpaid rentals, in which event said notice shall be of no effect. Such notice by the County shall be for the following periods:

(a) On and before January 1, 1966, 30 days notice of such election shall be given.

(b) After January 1, 1966, 90 days notice of such election shall be given.

18. It is further agreed that if the Company shall default in the performance of any of any of the terms, provisions, covenants or conditions on its part to be performed, kept or observed hereunder, other than the non-payment of rent hereunder, then and in any such event the County, at its election, may terminate this lease at any time thereafter by giving ninety (90) days written notice, which shall be mailed to the President of the Company at its principle office in Charlotte, North Carolina, and at the expiration of such ninety (90) day period, this lease and all of the estate, right, title and interest herein granted to or vested in the Company shall cease and terminate, unless within said ninety (90) day period all such default or defaults shall have been fully remedied, or the Company shall have commenced action and continued same in a reasonable manner to remove such default or defaults.

* * * *

21. The Company is granted the right to assign the Lease or sublet the whole or any part of the demised premises, subject to the approval of the original purchaser of both bond issues, or its successor; provided, however, that the Company shall at all times remain liable for the payment of the required rentals.

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No. 79-98

In the Supreme Court of the United States

OCTOBER TERM, 1978

JACK'S COOKIE COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
Department of Justice
Washington, D.C. 20530

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MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The question presented in this federal income tax case is whether petitioner's payment of $20,479.08 into a bond reserve fund in 1970 pursuant to the terms of a lease was a currently deductible rental expense under Section 162(a)(3) of the Internal Revenue Code of 1954 (26 U.S.C.), or, as the court of appeals held, a nondeductible capital outlay.

The pertinent facts are undisputed and may be summarized as follows: Petitioner is an Ohio corporation engaged in producing and selling cookies and other baked goods. In 1962, it entered into an agreement with the government of Giles County, Tennessee, to rent an industrial building to be constructed and equipped by the county. To finance this project, the County Court of Giles

County authorized two issues of interest-bearing industrial development bonds, each in the principal amount of $1,250,000, and each to mature serially over a 30-year period (Pet. App. 3a). See Tenn. Code Ann. §§ 6-1701 *et seq.*, 6-2901 *et seq.* (1971).

Under an agreement dated June 1, 1962, petitioner agreed to lease the building from Giles County for a primary term of 30 years at "monthly rentals" designed to equal the interest, principal payments, and administration expenses required on the industrial development bond issues. Petitioner also agreed to pay additional monthly rentals, which were described as "reserve payments" by the lease. The lease required the reserve payments to be paid in equal monthly installments over the first 15 years of the lease until the aggregate sum of $285,000 was accumulated in a bond reserve fund (Pet. App. 3a-4a, 30a-31a).

The indenture of mortgage executed by petitioner, the county and the trustee for the bondholders, expressly provided that the trustee had to accumulate the reserve payments in the bond reserve fund solely as security for the future payment of the bonds. In the event of default by petitioner, the bond reserve fund would be applied toward the payment of outstanding bond obligations. The indenture also provided that the trustee, at the direction of petitioner, would invest all surplus amounts in the bond reserve fund in direct obligations of the United States having a maximum maturity date of ten years. The interest earned on such investments was to be deposited in the bond reserve fund (Pet. App. 4a-5a; R. 51).[1]

[1]"R." refers to the record appendix filed in the court of appeals.

The lease agreement further provided petitioner with certain options to apply the bond reserve fund against its future rent liability. If, at any time after the fifteenth year from the issuance of the bonds, petitioner elected to prepay its remaining rentals due under the lease, it would receive a credit against its prepayment liability for the amounts then in the bond reserve fund (Pet. App. 5a, 31a). Petitioner could receive an identical credit if, in the case of damage to or condemnation of the premises, it chose to exercise its option to pay all remaining rentals and terminate the lease (Pet. App. 5a, 31a-36a).

On its income tax return for its taxable year ending October 2, 1970, petitioner included in its claimed rental expense deduction the amount of $20,479.08 for reserve payments it made to Giles County during that year pursuant to the lease agreement. On audit, the Commissioner of Internal Revenue disallowed the deduction on the ground that the payments made represented nondeductible capital expenditures.[2] In a refund suit brought by petitioner in the United States District Court for the Western District of North Carolina, the district court upheld petitioner's claimed rental deduction (Pet. App. 1a). The court of appeals reversed (Pet. App. 2a-24a). In the court of appeals' view, "the fund into which the reserve element of the rents was paid was essentially a 'separate and distinct asset' which must be capitalized" (Pet. App. 23a).

1. Petitioner argues (Pet. 5) that in holding its bond reserve fund payments to be nondeductible capital outlays, the court of appeals misapplied this Court's

[2]The Commissioner did allow petitioner a rental expense deduction for the remaining portion of the $191,720.92 it paid to Giles County during its taxable year 1970 (R. 14).

decision in *Commissioner* v. *Lincoln Savings & Loan Ass'n*, 403 U.S. 345 (1971). While Section 162(a) of the Code allows a current deduction for ordinary and necessary business expenses, including rental paid for business property, expenditures that are capital in nature are not currently deductible. See Section 263. Thus, where an expenditure, although required by business exigencies, results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, it must be capitalized. *Commissioner* v. *Lincoln Savings & Loan Ass'n*, *supra*; *United States* v. *Mississippi Chemical Corp.*, 405 U.S. 298 (1972); *Richmond Television Corp.* v. *United States*, 345 F. 2d 901 (4th Cir.), vacated and remanded on another issue, 382 U.S. 68 (1965). On the basis of this settled principle, the court of appeals correctly held that petitioner's payments into the bond reserve fund during 1970 were nondeductible capital expenditures (Pet. App. 2a-24a).

Here, the reserve payments at issue were not required by Giles County to satisfy any actual bond obligations during the taxable year in question. Instead, those payments were paid into the reserve fund as security for the future payment of the bonds in the event of default by petitioner. Moreover, under the lease petitioner retained substantial rights to have the bond reserve fund, and any investment income generated by the fund, applied for its benefit in subsequent taxable years. Thus, petitioner could elect to prepay its remaining rentals due under the lease, and if it did so, it would receive a credit against its prepayment liability for the balance then in the reserve fund.[3] Petitioner could receive a similar credit if, in case

[3]Petitioner conceded at oral argument in the court of appeals that would be " 'economically foolish' " not to prepay its rent at some time in order to get the full benefit of the amounts in the bond reserve fund as a credit against its future rent (Pet. App. 5a n. 6).

of damage to or condemnation of the premises, it exercised its option to pay all remaining rentals and terminate the lease. Under these circumstances, the reserve payments do not constitute deductible expenses, since, despite their characterization under the lease as "rentals," the payments were not made for petitioner's current use and occupancy of the premises. Moreover, there was a substantial possibility that the amounts would be applied for petitioner's benefit in the future. *Commissioner* v. *Lincoln Savings & Loan Ass'n*, *supra*. See also *Kohler-Campbell Corp.* v. *United States*, 298 F. 2d 911 (4th Cir. 1962); *Galatoire Bros.* v. *Lines*, 23 F. 2d 676 (5th Cir. 1928); *Minneapolis Security Building Corp.* v. *Commissioner*, 38 B.T.A. 1220 (1938).

There is accordingly no basis for petitioner's contention that the decision below is contrary to *Commissioner* v. *Lincoln Savings & Loan Ass'n*, *supra*. Indeed, as the court of appeals recognized (Pet. App. 24a), "there is little of significance to distinguish the two cases." In *Lincoln Savings & Loan Ass'n*, this Court held that certain insurance premium prepayments made by a savings and loan association into a reserve fund did not constitute deductible expenses in the year paid because the payments served to create or enhance "a separate and distinct additional asset * * *." 403 U.S. at 354. Here, as in *Lincoln Savings & Loan Ass'n*, petitioner has "a distinct and recognized property interest in the * * * [r]eserve" in an amount equal to the sum of the reserve payments plus any investment income earned thereon (Pet. App. 23a; R.

[4]Contrary to petitioner's further argument (Pet. 6-7), the fact that petitioner could not easily convert its interest in the bond reserve fund into cash or other liquid assets does not require a different result. The restrictions on petitioner's ability to control the reserve fund do not alter the fundamental capital character of that fund. *Commissioner* v. *Lincoln Savings & Loan Ass'n*, *supra*, 403 U.S. at 357.

85).[4] 403 U.S. at 355. The decision of the court of appeals is therefore entirely consistent with *Lincoln Savings & Loan Ass'n.*

2. Petitioner renews its arguement (Pet. 6-7), rejected by this Court in *Commissioner* v. *Lincoln Savings & Loan Ass'n*, *supra*, 403 U.S. at 358, that because its reserve fund payments represent a cash outlay which reduces its net income on its books for financial accounting purposes, the annual system of accounting for tax purposes requires that the payments be deducted in the year they are paid. That fact, however, is irrelevant. The expenditures here resulted in the creation of an asset having a useful life extending beyond the close of the taxable year and may not be deducted merely because the liability to make the payment became fixed during the taxable year. To the contrary, proper tax accounting requires that a deduction be allowed for the reserve fund payments as they are finally applied in future years to discharge petitioner's obligations under the lease.[5] Only in this manner will the income earned in a particular year be matched with the expense attributable to the production of that income. *Commissioner* v. *Lincoln Savings & Loan Ass'n*, *supra*; *United States* v. *Anderson*, 269 U.S. 422, 440 (1926); *Sandor* v. *Commissioner*, 536 F. 2d 874 (9th Cir. 1976); *Commissioner* v. *Boylston Market Ass'n*, 131 F. 2d 966 (1st Cir. 1942). See Treasury Regulations on Income Tax Section 1.461-1(a)(1) (26 C.F.R.).

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[5]Petitioner asserts (Pet. 7-8) that the decision below "conflicts in principle" with *Benton* v. *Commissioner*, 197 F. 2d 745 (5th Cir. 1952), and *WBSR, Inc.* v. *Commissioner*, 30 T.C. 747 (1958). But those cases involved the wholly different question whether an option to purchase at the expiration of a lease may characterize the lease as a contract of sale for tax purposes; the deductibility of a reserve payment was not in issue in either case.

3. Finally, petitioner argues (Pet. 7-8) that the reserve payments are deductible because it had a fixed liability under both the lease agreement and state law to make such payments as a condition to its continued use and possession of the premises. But as this Court made clear in *Commissioner* v. *Lincoln Savings & Loan Ass'n*, *supra*, 403 U.S. at 358-359, the fact that a payment is compulsorily imposed upon a taxpayer does not render it deductible (Pet. App. 6a-13a, 24a). See also *Duffy* v. *Central R.R.*, 268 U.S. 55 (1925); *Woolrich Woolen Mills* v. *United States*, 289 F. 2d 444 (3d Cir. 1961); *Teitelbaum* v. *Commissioner*, 294 F. 2d 541 (7th Cir. 1961).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

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